A View on Housing in the Recovery

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- Atlanta Fed President and CEO Dennis Lockhart, in a November 4, 2016, speech to the 2016 REALTORS Conference and Expo in Orlando, Florida, presents his views on housing in the economic recovery.
- Lockhart's outlook for the housing sector is optimistic because of demographic trends, projected household formation, and a moderately growing economy.
- Lockhart outlines housing demand factors including economic health, credit availability, and affordability.
- He also cites supply constraints: a shortage of affordable housing, tight inventories of homes for sale, and the regulatory environment.
- Lockhart states that even with the prospect of rising interest rates, policy is not disconnected from factors that should improve overall affordability, such as wage growth and employment prospects.
- He expects the rate environment to stabilize at a lower level than in past periods of sustained expansion, promoting affordability and a healthy sales market.

Introduction

It's been a busy week. As you may know, the Federal Open Market Committee, or FOMC, met Tuesday and Wednesday. The FOMC is the group in the Federal Reserve responsible for setting monetary policy, especially interest rate policy. The Committee took no action at this week's meeting and kept the policy rate where it's been since last December—in a range of 25 to 50 basis points.

I am going to try to make myself useful to you this morning. In the time I have, I'm going to focus on the factors that I expect will influence how many houses you'll sell in 2017 and coming years.

Let me provide you a roadmap of my remarks. I will comment on the factors influencing demand. They include the health of the general economy, credit availability, and affordability. I'll then comment on supply factors including inventory levels and residential investment or, more narrowly, new home construction.

The punchline will be positive. Despite some challenges, my outlook for the housing sector is, on net, optimistic. I think the longer-run housing outlook looks promising because of demographic trends and projected household formation. In the near term, the broad economy seems to be on a moderate growth path, which should be good news for your industry.

Before I get going, a disclaimer: I'll be offering my personal views. I'm not speaking for the Federal Reserve or the FOMC.

Demand factors

I'll start with comments on the general health of, and outlook for, the broad economy. I'll touch on the strength of the economy as a factor propelling housing demand.

Economic growth in 2016 will likely be a little below 2 percent. Expansion in the first half of the year was rather weak. The economy grew at an annual rate of 1.1 percent through June. The first estimate of the Bureau of Economic Analysis of third-quarter growth of GDP (gross domestic product) was nearly 3 percent. I had been expecting a growth rebound in the second half, so the headline number of 2.9 percent was welcome. I expect the fourth quarter and 2017 to be consistent with a continuing theme of moderate annual growth of around 2 percent.

The details of the third-quarter report carried mixed messages, but did not set off any alarm bells. Consumer activity backed off a little in the quarter that ended in September, but on the heels of second-quarter strength. Business fixed investment improved slightly, but remains subdued. Net inventory accumulation contributed to growth after having been a drag for several preceding quarters.

Residential investment is, appropriately, of particular interest to you. To generalize, this element of the growth picture has been somewhat soft, but improving. Monthly housing starts have been in the range of 1 million to just over 1.2 million annualized since early last year. Residential investment has historically been a contributor in a recovery, but this time less so.

Employment is an important channel through which the overall economy influences housing demand. Employment conditions continue to tighten. The pace of job gains has been stronger than the pace of economic growth over the last two years.

This morning we got the employment report for October. It showed a net gain of 161,000 jobs, and the unemployment rate ticked down a tenth to 4.9 percent. While I haven't had much time to dig into the details, the top-line numbers look solid.

Labor force participation has been in secular decline for a number of years, partly due to baby-boomer retirements. However, participation has risen a bit over the past year. Contrary to some reports, the uptick in participation is mostly due to fewer people leaving the workforce versus out-of-the-workforce people coming off the sidelines. This respite from the declining participation trend means the official unemployment rate has gone sideways for several months, but for good reasons.

We have been paying attention to wage growth as an indication of a tightening labor market. Wage growth is accelerating modestly. At the Atlanta Fed, we have our own tool called the Wage Growth Tracker. It tracks wage gains of continuously employed individuals, which means it is not influenced by newer, lower-wage entrants. Readings of our Wage Growth Tracker have risen to the highest level since the recovery began in 2009.

To summarize, job gains remain on a stable course, and the economy is approaching full employment. Conditions overall are favorable for your industry, in my opinion.

As you may know, the FOMC focuses on two specific policy goals—maximum employment and price stability, or low and stable inflation.

Inflation continues to trend below our 2 percent longer-run target. So an immediate policy objective is to get the rate of inflation closer to 2 percent. It’s fair to say inflation has been low and stable, just a bit below what the Committee considers the healthiest ongoing rate.

A positive economic environment should support house sales, especially if combined with favorable demographics. Millennials are the largest demographic group in the country, larger than my boomer generation.

The circumstances of millennials, as prospective home buyers, are mixed. They are living with their parents or remaining renters longer and starting families later. As recently as 2013, a third of 18- to 34-year-olds were living at home, according to research by Zelman and Associates. That is the highest number since 1970. Zelman’s research concludes that this phenomenon is not a permanent structural headwind. Their study in 2013 estimated pent-up demand in this age group of more than 1 million households, assuming a better economic environment. And much economic progress has been achieved since 2013.

Many millennials are entering the workforce with considerable student loan debt. So far, student loan debt does not appear to be a material threat to ultimate homeownership. Millennials with high student loan debt also tend to have higher incomes and can afford to purchase a home.

Although there may be fewer qualified first-time home buyers than typical at the moment, household formations should average on the order of 1.4 million to 1.5 million a year through 2020. This projection is based on work done at the San Francisco Fed using Census Bureau projections. Household formation should support house sales to some extent. Some of the pickup in household formations will fuel rental markets. The single family/multifamily mix appears to be changing, so a greater proportion could go to multifamily. All that said, studies have confirmed the intention of millennials to eventually be homeowners.

A third factor affecting demand conditions is credit availability. The Mortgage Credit Availability Index produced by the Mortgage Bankers Association suggests that credit availability through September has continued to slowly improve.

Through the first half of the year, banks reported strengthening demand for most categories of mortgage loans. Results from the August Federal Reserve Board Senior Loan Officer Opinion Survey indicate that some banks have continued to ease lending standards on loans eligible for purchase by Fannie Mae and Freddie Mac. A *Wall Street Journal* article this week addressed nonbank lenders' growing share of mortgage finance, especially in segments banks have deemphasized. This should result in wider credit availability.

Certainly, there are individual buyers who still face challenges qualifying for loans, especially borrowers at the lower end of the creditworthiness scale. But, overall, I think you can argue that credit for home purchases is gradually becoming more available.

One more factor influencing sales is affordability. The rise of house prices has been outpacing general inflation as well as growth of income. But as the National Association of Realtors' affordability index shows, low mortgage rates have been partially offsetting this unfavorable affordability drift.

I'm sure you are concerned about the future interest rate environment and its effect on affordability in individual cases. I anticipate a very gradually rising interest rate environment over the next two years. At the same time, I do not see rates marching higher for an extended period in a preprogrammed tightening campaign. The economy does not call for that, at least not at this time. Rate decisions will continue to be data-dependent and, therefore, meeting-to-meeting, in my view.

And when the rate environment does reach steady state, mortgage rates should still be low and affordable by historical standards. Over our last few official projections, we policymakers have revised lower our estimates of the so-called neutral policy rate. Think of the neutral rate as where we stop when policy goals have been substantially met and the economy is functioning well on a sustainable trend.

In my opinion, Realtors should not interpret the prospect of rising rates as ominous. Substantial economic progress has been achieved since the recession ended in 2009. The outlook is for moderate growth and improving conditions. And we are close to achieving the Fed's monetary policy objectives. Although higher interest rates will raise the monthly payment cost of housing for some new borrowers, policy is not disconnected from factors that should improve overall affordability—factors like wage growth and employment prospects.

Supply factors

My colleagues and I *are*, however, concerned about the housing affordability trend—both rental and purchase—for lower-income households. Many urban areas are seeing a distressing shortage of affordable housing. Research done recently by the McKinsey Global Institute concludes that, in California for example, 50 percent of households cannot afford housing in their local market. McKinsey goes on to argue "…virtually none of California's low-income and very-low-income households can afford the local cost of housing." I would argue that the supply of affordable housing is not only an economic inclusion issue, but one that affects labor mobility and the overall efficiency of urban economies that increasingly are the dominant force in national output.

With that problem in mind, let me shift now to *supply* factors that will influence industry sales next year and over the medium term.

I don't need to remind this audience that inventories of houses for sale are tight. The months' supply of inventory estimate is below five.

Inventory levels across markets are being limited by available land, available construction labor, and stronger supervisory guidance as regards acquisition, development, and construction (ADC) lending.

Since the recession, homebuilders have been more selective in their new home construction projects. Many homebuilders have, of necessity, shifted their development activity well above historic entry-level price points. Today, only 28 percent of newly built homes are priced below $250,000, down from 43 percent before the financial crisis. The homebuilders we talk with cite cost constraints as the driver of this trend.

They also mention the regulatory environment of lenders. Lending for acquisition, development, and construction activity has tightened considerably. Banks that went into the Great Recession with the highest exposures to ADC loans typically had the most financial distress, and many failed. As a result, supervisory guidance has become more explicit about concentration levels and project risk when it comes to this type of lending. Also, new consumer compliance regulations have added complexity and associated costs to real estate transactions.

Let me close with a few summary thoughts. The housing sector has challenges, of course. But the housing industry's near-term outlook, as I see it, is one of continued improvement in the context of moderate economic growth. The longer-term housing outlook looks promising, supported by demographic trends, employment growth, and credit availability. I think it's prudent to expect a rising interest rate environment, but I would expect the rate environment to stabilize at a lower level than in past periods of sustained expansion. Such an environment should promote affordability and a healthy sales market.